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# A LAW FIRM PENSION PLAN?

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Two areas of tax law meet here. One relates to pension plans and the other relates to the treatment of unincorporated organizations as corporations for tax purposes.

Substantial tax advantages can be obtained if an employer establishes a pension plan, meeting certain requirements, for the benefit of his employees. An employer may deduct his contributions to the plan.[1] Income earned by principal accummulated under the plan is exempt from income taxation.[2] Contributions made by the employer are not taxed to the employees when the contributions are made but only when benefits are distributed or made available to them,[3] and if the interest of an employee is distributed within one taxable year on account of his death or separation from the employer's service, his gain is taxed only as long-term capital gain.[4] Because of these tax advantages, a qualified pension plan is especially beneficial to persons in high tax brackets. Their contributions to such a plan may give them much greater after-tax benefits than they would receive from comparable increases in salary.

The Internal Revenue Code extends these privileges, however, only to a plan "of an employer for the exclusive benefit of his employees or their beneficiaries."[5] Thus a plan does not qualify if the employer is included as a participant.[6] This does not create difficulties in the case of a corporate employer, because shareholder-employees may participate in a plan without necessarily preventing it from qualifying.[7] However, it prevents an individual proprietor or a member of a partnership from participating in a qualified plan.

This situation has led to efforts in two directions. First, legislation has been proposed to allow the self-employed to deduct sums which they set aside for their own retirement. H. R. 10, to this effect, is now under consideration. Second, some unincorporated groups have sought to use the concept of an "association" to gain the income tax treatment of a corporation and thus to establish qualified pension plans.

The Commissioner has long used the concept of an "association" to extract additional taxes. This concept appears in the definition of a corporation, which is stated to include associations, joint-stock companies, and insurance companies.[8] Thus, the Commissioner has been able to impose the corporate income tax on the group and then to tax its members on amounts distributed to them, as dividends. This approach has not been much of a threat to partnerships of doctors or lawyers, probably because such partnerships have rarely desired to imitate the basic characteristics of a corporation and because such partnerships, if treated as associations, could usually de-

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1 Int. Rev. Code of 1954, § 404.
2 Int. Rev. Code of 1954, § 501(a).
3 Int. Rev. Code of 1954, § 402(a).
4 Int. Rev. Code of 1954, § 402(a)(2).
5 Int. Rev. Code of 1954, § 401(a).
6 I.T. 3268, 1939-1 Cum. Bull. (Part 1) 196.
7 Treas. Reg. § 1.401-1(b)(3) (1956), as amended, T. D. 6301, 1958-2 Cum. Bull. 197.
8 Int. Rev. Code of 1954, § 7701(a)(3).

duct substantially all of the earnings of the group as salaries paid to members, so that no substantial corporate tax would be incurred.

Because of present interest of doctors and lawyers in setting up qualified pension plans, however, we must inquire into the law which developed when the concept of an association was used primarily to collect more taxes from unincorporated groups. The leading case was *Morrissey v. Commissioner*.[9] In that case, real estate was transferred to trustees. They were authorized to choose their successors, to buy, sell, and operate land, to construct and operate golf courses and club houses, to receive the income, to make investments, and generally to manage the property as if they were the owners. The trustees had no power to create liability personal to the beneficiaries. The beneficiaries were to get transferable certificates of interest. Neither the death of a trustee nor that of a beneficiary was to terminate the trust. The Supreme Court held that the group was an association and could be taxed as a corporation. It said, "The inclusion of associations with corporations implies resemblance; but it is resemblance and not identity."[10] The Court indicated that the result was influenced by: the existence of associates in an enterprise for doing business and provisions making for continuity of existence, centralization of management, transferability of beneficial interests, and limited liability.

Which factors were most significant? It has been thought that they were centralization of management and continuity of life.[11] This seems to have been the position of the Treasury Department under the 1939 Code.[12]

The next question is this: does local law govern in deciding whether the essential characteristic of an association exists? The regulations under the 1939 Internal Revenue Code gave the impression that it did not. They included this statement:

> For the purpose of taxation the Internal Revenue Code makes its own classification and prescribes its own standards of classification. Local law is of no importance in this connection. Thus, . . . [t]he term "corporation" is not limited to the artificial entity usually known as a corporation, but includes also . . . certain kinds of partnerships.[13]

The Supreme Court used language pointing the same way:

> Neither the conception of unincorporated associations prevailing under the local law, nor the relation under that law of the association to its shareholders, nor their relation to each other and to outsiders, is of legal significance as bearing upon the power of Congress to determine how and at what rate the income of the joint enterprise shall be taxed.[14]

The regulations might have been interpreted to mean only that federal law determined the standards of classification of an association and that local law determined whether those standards are met in a given case; but the language of the Supreme Court seems to give local law no effect.

Only one case, apparently, held that a group of professional men

9 296 U.S. 344 (1935).
10 *Id.* at 357.
11 Driscoll, *The Limited Partnership and the Association Question*, 1960 So. Calif. Tax Inst. 539, 553.
12 Treas. Reg. 118, § 39.3797-2, 39.3797-4(a) (1953).
13 Treas. Reg. 118, § 39.3797-1 (1953).
14 Burk-Waggoner Oil Ass'n v. Hopkins, 269 U.S. 110, 114 (1925).

was taxable as an association, before such classification became a benefit rather than a burden. That case was *Pelton v. Commissioner*.[15] There, several doctors transferred their equipment to themselves as trustees, with authority to operate a clinic or any allied business. They agreed that the trustees should not be personally liable for acts done in performing their duties. This attempt to limit liability apparently did not apply to the individual doctors as doctors. There was a provision for filling vacancies among the trustees. The beneficial interests were held by the transferors and were to be transferable by them, subject to an option in the other beneficiaries to buy before there should be any transfers to outsiders. During the taxable years in question, the transferors were the only beneficiaries. Thus, this organization had provisions for continuity of life and modified transferability of interests but did not really have centralization of management or limited liability. The Court, however, thought that the four characteristics of continuity, centralization, limited liability, and transferability were sufficiently present so that the organization should be treated as an association, subject to the corporate income tax.

The question of whether a professional partnership can be treated as an association became acute when pension plans became popular. Then it was seen that the concept of an association might be turned against the Commissioner. In *United States v. Kintner*,[16] a partnership of doctors dissolved and reorganized as an unincorporated association. Eight doctors became members. They delegated management to an executive committee of five. It was provided that the interests of members should be non-assignable and that the death or retirement of a member would not dissolve the association. There seems to have been no attempt to protect the members of the group from personal liability.

The court held that the clinic was an association for tax purposes and that its pension plan, which included primarily the doctors who were the members of the association, was a qualified plan. The court said:

> It should be added that it would introduce an anarchic element in the federal taxation if we determined the nature of associations by State criteria rather than by special criteria sanctioned by the tax law, the regulations and the

15 82 F. 2d 473 (7th Cir. 1936).
16 216 F. 2d 418 (9th Cir. 1954).

> courts. It would destroy the uniformity so essential to a federal tax system,—a uniformity which calls for equal treatment of taxpayers, no matter in what State their activities are carried on. For it would mean that tax incidences as to taxpayers in the same category would be determined differently according to the law of the State of residence.[17]

Recently, a similar decision was made by a federal district court in Texas.[18] In that case, a group of seven doctors formed an association to replace a partnership. Their motive, as found by the court, was to solve problems relating to a need for centralized management, limitation of liability of the individual doctors, continuity of life, and a better method of holding title to the property. They agreed to elect a board of directors of six, which was to appoint an executive committee of two to handle details, subject to control by the board of directors. Interests of the members were to be transferable, subject to an option in the group and the other members to buy at the offering price. It was provided that the members should not be liable for debts of the group or of any member until the assets of the group and of the defaulting member should be exhausted. Assets of the group were not to be distributed until the termination of the association, which was to last for 35 years. The agreement of the parties, then, purported to provide for centralization of management, continuity of life, and modified transferability of interests. It did not establish limited liability like that of corporate stockholders. The government took the position that the taxpayer, a member of the association, was taxable on his proportionate interests in a reserve fund set aside by the association and returned by it as corporate income. The court held for the taxpayer.

The government has not acquiesced in the *Kintner* or *Galt* decisions.[19] For a time, it held that if a partnership adopted the corporate form to get the benefits of a qualified pension plan, it was a partnership for all purposes.[20] Later it ruled that the mere fact that a group attempted to set up a qualified pension plan would not determine whether it was a partnership or an association.[21]

Now, proposed regulations have been issued.[22] Our present question, then, is: are those regulations consistent with the decided cases, and will it be practicable, under them, for a professional partnership to adopt such a form as to be able to establish a qualified pension plan? It seems generally to be assumed that, if a professional partnership can so reorganize as to be an "association," its members will be treated as "employees" under the provisions relating to pension plans, but at least one source has urged caution as to this.[23]

A striking feature of the proposed regulations is the following language:

Although it is the Internal Revenue Code rather than local

17 216 F. 2d 418, 424 (9th Cir. 1954).

18 Galt v. United States, 175 F. Supp 360, 1959-2 U.S. Tax Cas. 73,513 (N.D. Tex. 1959). (The facts in this case are reported in U.S. Tax Cas. but not in F. Supp.).

19 The government appealed the *Galt* decision, but the appeal was dismissed on November 24, 1959. No further details as to the dismissal appear to be available.

20 Rev. Rul. 56-23, 1956-1 Cum. Bull. 598.

21 Rev. Rul. 57-546, 1957-2 Cum. Bull. 886.

22 Proposed Treas. Reg. § 301.7701, 24 Fed. Reg. 10450 (1959).

23 Tax Approaches, Charles D. Spencer & Associates, Inc., February, 1960.

law which established the tests or standards which will be applied in determining the classification in which an organization belongs, local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met. Thus, it is local law which must be applied in determining such matters as the legal relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets.[24]

Although one might rationalize the language of the old regulations, which are quoted above, so as to render it consistent with that of these proposed regulations, the mood and emphasis of the Treasury Department seem definitely to have changed. It seems impossible to reconcile the language of the proposed regulations with that of the Supreme Court in *Burk-Waggoner Oil Ass'n v. Hopkins,* also quoted above, or with the fact that in the other cases the courts have looked only to the agreements made by the parties, without reference to the local law.[25]

To weigh the effect of the proposed regulations, however, we need to learn what standards they set up for determining whether an organization is an association. They state six standards:

i. Associates,
ii. An objective to carry on business and divide the gains therefrom,
iii. Continuity of life,
iv. Centralization of management,
v. Liability for corporate debts limited to corporate property,
vi. Free transferability of interests.[26]

The first two standards are common to partnerships and corporations, so that our problem centers around the meaning of the remaining four standards and the possibility of meeting them.

When does the organization have "continuity of life"? "An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization."[27] The regulations state that, al-

24 Proposed Treas. Reg. § 301.7701-1(c), 24 Fed. Reg. 10451 (1959).
25 Bittker, The Corporation Income Tax 30 (1959).
26 Proposed Treas. Reg. § 301.7701-2(a), 24 Fed. Reg. 10451 (1959).
27 Proposed Treas. Reg. § 301.7701-2(b)(1), 24 Fed. Reg. 10451 (1959).

though the parties may agree that none of these events shall dissolve the organization, there is not continuity of life if under local law the organization may be dissolved by the occurrence of one of these events or by an act of a member of the group, even though that act is a violation of the agreement.[28] Under Colorado law, the expulsion of a partner, the death or bankruptcy of a partner, or an expression of the will of any partner at any time, although in violation of the agreement of the parties, dissolves a partnership.[29] Also, a partner or a purchaser of the interest of a partner can get a judicial decree dissolving a partnership.[30] Thus a Colorado partnership cannot meet the standard of continuity of life set by these regulations.

The next standard discussed by the proposed regulations is centralization of management. The regulations state that this standard is met if "any person (or group of persons which does not include all members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed."[31] The regulations also state, however, that in the case of a general partnership an agreement that the powers of management shall be exclusively in a selected few is ineffective against outsiders without notice and that therefore a general partnership cannot meet this standard.[32] Here the regulations have stated the effect of local law, which seems odd, but they have done it correctly.[33] Thus the standard of centralization of management cannot be met.

Another standard is limited liability. It is said to exist "if there is no member who is personally liable for the debts of or claims against the organization."[34] Under Colorado law, however, all partners are liable for the debts of the partnership, so that this standard cannot be met.[35]

The last standard is that of transferability of interests. This requires that each member be able, without the consent of the others, to substitute an outsider for himself. He must be able to transfer all of the attributes of his position, not only his right to share in profits but also his right to participate in management.[36] The regulations recognize that members of a partnership may be unwilling to permit transfers of interests without having a right first to buy those interests for themselves. Thus it is stated that a modified form of transferability exists if there is such an option but that this form of transferability has less weight.[37] Under Colorado law, a partnership can make an effective agreement that a partner may assign his interest and that the assignee will step completely into the shoes of the transferor.[38] The difficulty here may be a practical one, that members of a law firm, because of the personal character of the relationship among the partners, may be unwilling to make such an

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28 Proposed Treas. Reg. § 301.7701-2(b)(2),(3), 24 Fed. Reg. 10451-2 (1959).
29 Colo. Rev. Stat. § 104-1-31 (1953). (Uniform Partnership Act, § 31).
30 Colo. Rev. Stat. § 104-1-32 (1953). (Uniform Partnership Act, § 32).
31 Proposed Treas. Reg. § 301.7701-2(c)(1), 24 Fed. Reg. 10452 (1959).
32 Proposed Treas. Reg. § 301.7701-2(c)(4), 24 Fed. Reg. 10452 (1959).
33 Colo. Rev. Stat. § 104-1-9 (1953). (Uniform Partnership Act, § 9).
34 Proposed Treas. Reg. § 301.7701(d)(1), 24 Fed. Reg. 10452 (1959).
35 Colo. Rev. Stat. § 104-1-15 (1953). (Uniform Partnership Act, § 15).
36 Proposed Treas. Reg. § 301.7701-1(c)(1), 24 Fed. Reg. 10452 (1959).
37 Proposed Treas. Reg. § 301.7701-1(e)(2), 24 Fed. Reg. 10452 (1959).
38 Colo. Rev. Stat. §§ 104-1-18, 27 (1953). (Uniform Partnership Act, §§ 18, 27).

agreement, even though they provide that any interest must be offered to present partners before it is transferred to an outsider.[39]

Must a group qualify in respect to all of the standards set by the regulations to be treated as an association? Apparently, it need not. The text states that "[a]n organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust."[40] The regulations include examples which indicate that an organization may be treated as an association if it has the modified form of transferability of interests and meets two of the standards of continuity of life, centralization of management, and limited liability. Modified transferability plus only one of the other characteristics, such as centralized management, is treated as insufficient.

Thus, the proposed regulations look to local law to determine whether the standards are met, and under Colorado law those standards cannot be met. This situation is not peculiar to Colorado. Our statutes are based on the Uniform Partnership Act, which is law in at least 38 states and Guam. The same results are likely to occur in other states, since the act is largely in accord with the common law.[41]

Would it be possible to comply with the proposed regulations by adopting a form that would not be that of a general partnership under local law but would be that of a limited partnership or a

39 Stutsman, *New Kintner Regs. not Retroactive, Give Specific Criteria to Test Partnership*, 12 J. Taxation 174, 176 (1960).
40 Proposed Treas. Reg. § 301.7701-2(a)(1), 24 Fed. Reg. 10451 (1959).
41 Crane, Partnership and Other Unincorporated Associations 7 (2nd ed. 1952).

trust? This seems doubtful. Limited partners contribute property to the firm rather than services, so that a limited partnership does not appear adaptable to the practice of law.[42] Is the use of the trust form a better possibility? Under principles of trust law, a business can be organized in such form as to provide continuity of life, centralization of management, limited liability, and transferability of interests, within the meaning of the proposed regulations.[43]

Here, however, we meet objections based on legal ethics. The Committee on Professional Ethics of the American Bar Association has already ruled that it would be improper for members of a law firm to transfer their interests in the firm to a trust which would employ the members of the firm and create a pension or profit-sharing plan for their benefit.[44] The committee thought that the specific proposal before it would not create a trust, because of control over the trustees reserved to the beneficiaries. At some length, however, the committee argued that even if a trust were created the arrangement would violate several of the Canons of Professional Ethics.

Canon 33 prohibits misleading use of a firm name. The committee thought that the proposed plan would violate this canon by giving the impression that the firm was a partnership, rather than a trust. A potential client, if he considered the problem of liability for malpractice, might suppose that all members of the firm would be personally liable for the act of any member. This supposition seems to be correct in the case of a general partnership; if the firm were a trust, however, only the trustees and the corpus, through the right of the trustees to reimbursement, would be liable for the acts of lawyers employed by the trust. Thus there may theoretically be some merit in this objection by the committee. That this objection has practical importance seems doubtful.

Canon 34 forbids splitting fees with laymen. The committee thought that this canon would be doubly violated by the proposal. First, the fees would be paid to the trustees and would be used by them, in part, to pay clerks and stenographers. Second, beneficial interests in the trust, through death or otherwise, might pass to laymen. The first objection seems weak, since part of the fees received by a lawyer generally do go to his clerks and stenographers. The second might be avoided by prohibiting transfers of beneficial interests to laymen and by making an agreement for the purchase of the interest of any retiring member of the firm, either by the firm or by its members.

Canon 35 prohibits the intervention of a lay agency between a lawyer and his client. The committee thought this canon would be violated by a provision that all fees be paid to the trustees. The proposal would have required the trustees to be lawyers, so it is dif-

42 Colo. Rev. Stat. § 104-2-4 (1953). (Uniform Limited Partnership Act, § 4).

43 Proposed Treas. Reg. § 301.7701-4(b),(c) example 2, 24 Fed. Reg. 10454 (1959). It might be noted that the limited liability available in the case of a trust relates to liability for acts of the trustees, not to liability for the acts of beneficiaries rendering personal services. Thus, it seems improbable that the operation of a legal or medical firm through a trust device, even if otherwise feasible, would protect a member of the firm from liability for his own malpractice. As a practical matter, this seems to be the more significant liability for a doctor or a lawyer. For the purpose of classifying a group as an "association" however, the lack of personal liability for acts of the trustees may be the significant factor.

44 Opinion 283, 36 A.B.A.J. 870 (1950).

ficult to see how it would violate this canon any more than the usual operation of a large law firm.

It may be that the objections raised by the Committee on Professional Ethics are not very weighty. Its opinion must be considered, however, and we should also keep in mind that the objections made to the use of the form of a trust seem equally applicable to an imitation of corporate form.

Assuming that the Committee on Professional Ethics might change its opinion or that it might approve a different plan, is there any possibility of solving the tax difficulties in the way of establishing a qualified pension plan for a law firm? If the proposed regulations become final in their present form, the courts may hold them invalid. Their emphasis on local law is inconsistent with the language of the Supreme Court and the Court of Appeals for the Ninth Circuit. Furthermore, that emphasis is inconsistent with the results in the *Pelton, Kintner,* and *Galt* cases that involved groups of professional men. The leading *Kintner* case, dealing with the taxable year 1948, arose in Montana, where the Uniform Partnership Act had been adopted in 1947. It would seem in some areas of federal taxation, the courts have given considerable weight to local law. For example, nothing is included in the gross estate of a decedent on account of a life estate held by him but created by another; state law governs as to whether the decedent in fact had a life estate.[45] It might be said, in general, that federal law determines the tax consequences of the rights and duties of a taxpayer, but state law is used to decide what his rights and duties are. The proposed regulations fit this approach. Anyone considering the possibility of contesting their validity ought to study other areas in which this problem of state versus federal law has arisen.[46] He should also consider the problem of whether the interpretation of the statute here has become so settled by the existence of regulations and decisions and the passage of time that the Treasury Department cannot change it prospectively.[47] The Treasury may revise the proposed regulations so as to make the provisions of the agreement among the parties govern, even though they may deprive members of a firm only of the right to take certain steps and not of the power.[48] It now seems more probable, however, that the Treasury definitely wants to discourage professional partnerships from adopting the form of an association. An Under Secretary of the Treasury has recently written that:

45 Helvering v. Rhodes Estate, 117 F. 2d 509 (8th Cir. 1941).

46 This subject is considered at length in 10 Mertens, The Law of Federal Income Taxation, §§ 61.01-61.09 (Zimet and Stern rev. 1958).

47 1 Mertens, The Law of Federal Income Taxation, §§ 3.20-3.25 (Zimet, Stanley, and Kilcullen rev. 1956).

48 For arguments that this should be done see: Saltz, *Associations*, 38 Taxes 187, 191 (1960); Stutsman, *New Kintner Regs. not Retroactive, Give Specific Criteria to Test Partnership*, 12 J. Taxation 174, 177 (1960); Net After Taxes, Vol. VII, No. 8, April 1960.

> The Internal Revenue Service has administrative problems in dealing with partnerships which attempt to be treated as associations in order to allow the members to obtain coverage under qualified pension plans. This constantly raises difficult questions of substance over form.[49]

Congress has had under consideration for some time a bill which would permit self-employed individuals to make deductible contributions to retirement plans for their own benefit. If such a bill becomes law, the interest of professional partnerships in the use of the form of an association may die, except where there are practical, non-tax advantages in that form. Fringe benefits other than pensions may be provided through the form of an association, but it is not known whether they alone would create substantial interest in the use of that form.

The Treasury has, however, opposed that bill, and now has made a counter-proposal. The gist of this proposal is that the provisions relating to pension and profit-sharing plans for employees be revised so that an individual proprietor or a partner may treat himself as an employee and participate in such a plan. There are several limitations in the proposal: 1. Participation would have to be open, on a non-discriminatory basis, to employees who are not owners of the business. 2. The owner could participate only if he performed personal services. 3. Contributions for the benefit of the owner would be limited, at least if none of his employees received substantial vested interests, and 4. the Treasury would like to abolish the present capital-gains treatment of distributions made in one year on termination of service. This change would apply to all pension and profit-sharing plans, regardless of whether the owner of the business is a participant. For this privilege, the Treasury proposes to substitute some type of averaging of income.

The limitations in the Treasury's proposal do not seem severe. At present corporations appear able to establish pension plans primarily for the benefit of the shareholder-employees, because they are permitted to exclude many other employees, such as those paid wages and those who have been employed for less than five years. Most law firms have few employees, especially with service of five years or more, and the inclusion of long-term employees would probably not be an unjustified hardship on a firm.

We do not, of course, know whether Congress will adopt the proposal of the Treasury Department. When it adopted provisions permitting unincorporated businesses to elect to be taxed as corporations, it specifically provided that a partner or proprietor of such a business shall not be considered an employee for purposes of the sections relating to employees' pension trusts.[50] The fact that this present proposal comes from the Treasury Department may make a substantial difference.

If this proposal is adopted, it seems to answer our problem. Lawyers will be able to participate in pension plans with substantial tax advantages, and they will not have to change their mode of operations or risk professional disapproval to do it.

49 Letter of Under Secretary Fred C. Scribner, Jr. to Senator Harry F. Byrd, Chairman, Committee on Finance, April 1, 1960.
50 Int. Rev. Code of 1954, § 1361(d).